REVIEW OF FINANCIAL STATEMENT REPORTING FOR THE FINANCIAL INTERCHANGE

Report No. 00-11, May 30, 2000

EXECUTIVE SUMMARY

This report presents the results of the Office of Inspector General's (OIG) review of financial statement reporting for financial interchange (FI) transactions.

The Railroad Retirement Board (RRB) administers the comprehensive retirement and survivor benefit programs established by the Railroad Retirement Act (RRA) for the nation's railroad workers and their families. Approximately 748,000 annuitants received benefits under the RRA during fiscal year (FY) 1999.

In 1951, Congress enacted amendments that increased benefit levels under the RRA. This legislation guaranteed that benefits paid under the RRA would never be less than what would have been payable if the worker's railroad earnings had been credited as Social Security employment instead of RRA covered compensation. As part of that same legislative package, Congress established the FI between the Social Security and Railroad Retirement systems as an additional funding source. When the Medicare program was enacted in 1965, the Health Care Financing Administration (HCFA) became a party to the FI. In FY 1999, the RRB reported financing sources totaling $9.6 billion of which 32% were attributable to the FI.

The FI is a collective term that describes a series of legally mandated periodic fund transfers between the RRB and the Social Security Administration, the RRB and HCFA, and the RRB and the Department of the Treasury. The amounts transferred are the result of a complex statistical projection based on the scenario "what if the RRA had never been enacted."

The FI transfer amounts, for the period 1937 through the end of the preceding fiscal year, are determined after the financial statements for that year have been published. As a result, the RRB estimates FI receivables and payables for financial reporting purposes in accordance with traditional accrual accounting principles.

<u>Accrual Accounting</u>

Subject to applicable accounting standards, the RRB prepares annual financial statements on the accrual basis of accounting. Under the accrual method, revenues are recognized when earned and expenses are recognized when a liability is incurred. This contrasts with cash-basis accounting in which revenues are recorded when received in cash and expenditures are recorded when paid.

Based on our examination of the RRB's financial statements and pertinent public and governmental accounting literature, the OIG believes that non-accrual accounting for FI transactions would provide a more consistently reliable presentation than accrual-basis reporting. The RRB's Bureau of Fiscal Operations believes that accrual accounting best represents the financial relationships between the several agencies involved and most accurately depicts the agency's financial position.

In this report, the OIG recommends that the Bureau of Fiscal Operations submit a request for an interpretation of current Federal accounting standards as they apply to the FI to the Accounting and Auditing Policy Committee of the Federal Accounting Standards Advisory Board.

The Bureau of Fiscal Operations has agreed to prepare the recommended request for consideration by the agency's three-member Board.

Disclosure

Events that are expected to have monetary impact on the FI determination, but for which no monetary estimate can be made, may be pending at the end of the fiscal year. Such events are contingencies that require financial statement disclosure. In FY 1998, financial statement disclosures were expanded to include the past effect of such pending events. However, no disclosure of these events was made in the published financial statements for the years actually impacted.

In this report, we recommend that, as part of the financial statement preparation process, the Bureau of Fiscal Operations inquire about pending events that could alter the value of the FI receivables and payables and make disclosures as appropriate.

The Bureau of Fiscal Operations concurs with the recommendation.

Management’s Discussion and Analysis

“Management’s Discussion and Analysis,” the narrative overview published with the RRB’s FY 1999 financial statements, does not adequately communicate the extent to which the Railroad Retirement program is financially dependent on the Social Security system. In this report, we recommend that the Bureau of Fiscal Operations review and revise the narrative presentation of FI information published with the financial statements to better communicate the role of the FI as a key financing source.

The Bureau of Fiscal Operations concurs with the recommendation.

Auditor’s Opinion

We have concluded that the use of accrual accounting estimates to report FI payables and receivables has, in the past, led to material misstatement of the RRB’s financial statements. Disclosure of the historical differences between amounts estimated for financial statement reporting and amounts ultimately realized does not adequately compensate for potential misstatement in current period reports. As a result, the OIG was precluded from expressing an opinion on the RRB’s FY 1999 financial statements.

In the “Letter to Management” issued in conjunction with the OIG’s audit of the RRB’s FY 1998 financial statements, we recommended a change in accounting principle “to record and report on financial interchange amounts during the year of settlement.” Accordingly, we make no further recommendations for corrective action.

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INTRODUCTION

This report presents the results of the Office of Inspector General's (OIG) review of financial statement reporting for financial interchange (FI) transactions.

Background

The Railroad Retirement Board (RRB) is an independent agency in the executive branch of the Federal government. The RRB administers the comprehensive retirement and survivor benefit programs established by the Railroad Retirement Act (RRA) for the nation's railroad workers and their families. The RRB also has responsibilities under the Social Security Act for certain benefit payments and railroad worker's Medicare coverage. Approximately 748,000 annuitants received benefits under the RRA during fiscal year (FY) 1999.

The regular RRA annuity is composed of tier I benefits, based on railroad and non-railroad earnings, and tier II benefits which are computed using railroad compensation only. In addition to the tier I and tier II benefits, individuals who were considered vested under both the RRA and the Social Security Act at the end of 1974 may be entitled to an additional benefit known as the Vested Dual Benefit. A supplemental annuity may be available to career railroad employees who worked in the railroad industry prior to October 1981 and meet certain service-related requirements.

The funding structure of the Railroad Retirement system is closely related to the various benefits provided under the RRA. Each type of benefit is funded separately. Prior to 1951, RRA benefits were funded exclusively by payroll taxes levied on employers and employees covered by that Act.

In 1951, Congress enacted amendments that increased benefit levels under the RRA. This legislation guaranteed that benefits paid under the RRA would never be less than what would have been payable if the worker's railroad earnings had been credited as Social Security employment instead of RRA covered compensation. As part of that same legislative package, Congress established the FI between the Social Security and Railroad Retirement systems as an additional funding source. When the Medicare program was enacted in 1965, the Health Care Financing Administration (HCFA) became a party to the FI.

In FY 1999, the RRB reported financing sources totaling $9.6 billion of which 32% were attributable to the FI.
The Railroad Retirement Solvency Act of 1983 established the Social Security Equivalent Benefit Account (SSEB), separate from the Railroad Retirement Account. The purpose of this fund segregation was to track the income and outgo related to the FI and that portion of RRA benefits designated as “Social Security Equivalent.”

Subject to applicable accounting standards, the RRB prepares annual financial statements on the accrual basis of accounting. Under the accrual method, revenues are recognized when earned and expenses are recognized when a liability is incurred. That contrasts with cash-basis accounting in which revenues are recorded when received in cash and expenditures are recorded when paid, without regard to the accounting period to which the transactions apply.

Independent public accountants and the OIG issued disclaimers of opinion on the RRB’s financial statements for FY 1993 – FY 1999.[1] Beginning with FY 1994 statements, the auditors cited a scope limitation related to the accrual estimates used to report FI receivables and payables as the basis for their disclaimer.[2]

The Federal Accounting Standards Advisory Board (FASAB) is the authoritative standards-setting body whose Statements on Federal Financial Accounting Standards (SFFASs) lead the hierarchy of Federal accounting standards established by the Office of Management and Budget. FASAB’s Accounting and Auditing Policy Committee has authority to provide guidance related to existing accounting standards.

This audit was performed in conjunction with the OIG’s audit of the RRB’s financial statements for the fiscal year ended September 30, 1999.

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[1] Audits of the RRB’s financial statements were conducted by Arthur Andersen LLP(FY 1993 –FY 1995), KPMG Peat Marwick LLP (FY 1996) and the OIG (FY 1997 - FY 1999).
[2] Arthur Andersen LLP did not cite the FI as a cause for its disclaimer of opinion on the FY 1993 financial statements. Completion of the first audit of the agency’s financial statements was inadvertently delayed until after the FI determination and transfer had been completed for the fiscal year under examination.

Objective, Scope and Methodology

The objective of this review was to determine whether:

1. all revenue, expenses, assets and liabilities related to the FI have been properly valued in conformity with generally accepted accounting principles (GAAP) and FASAB standards, consistently applied;

2. all revenue, expenses, assets and liabilities related to the FI have been adequately disclosed; and

3. the presentation of FI information in management's narrative overview meets the requirements of OMB 97-01, "Form and Content of Federal Financial Statements."

To accomplish our objective, we:

- obtained an understanding of the FI;
- reviewed pertinent accounting standards;
- reviewed accounting records;
- reviewed previously published financial statements, audit reports and selected workpapers from prior audits; and
- discussed the issues with management in the Bureau of Fiscal Operations.

The work was performed in accordance with generally accepted government auditing standards as applicable to the audit objectives. Fieldwork was conducted at RRB headquarters during October 1999 through March 2000.

Results of Review

We reviewed the history of the FI accrual accounting estimates, applicable accounting standards and their impact on the financial statements. Based on our analysis, we have concluded that the accrual treatment of FI transactions is not entirely consistent with current accounting standards and has, in the past, led to material misstatement of the RRB's financial statements. We also noted that the agency has not disclosed pending events that could impact the value of the FI receivables and payables.

"Management's Discussion and Analysis," the narrative overview published with the RRB's FY 1999 financial statements, does not adequately communicate the extent to which the Railroad Retirement program is financially dependent on the Social Security system. Since the FI is a major financing source, such an understanding is critical to financial statement users.

In the past, the risk of material misstatement related to FI payables and receivables has precluded the OIG from expressing an opinion on the RRB's financial statements.

A detailed discussion of the accounting issues and the OIG's recommendations for corrective action follow.

ACCOUNTING FOR FI TRANSACTIONS

The FI is a collective term that describes a series of legally mandated periodic fund transfers between:

- the RRB and the Social Security Administration (SSA)(annually);
- the RRB and the Health Care Financing Administration (HCFA) (annually);and
- the RRB and the Department of the Treasury (Treasury) (monthly and annually).

The affected trust funds and accounts are:

- SSA's Federal Old Age and Survivor Insurance Trust Fund;
- SSA's Federal Disability Insurance Trust Fund;
- HCFA's Federal Hospital Insurance Trust Fund;
- RRB's Social Security Equivalent Benefit Account; and

- General Fund of the U.S. Treasury.

All of the annual transfers include interest calculated at the same rate through the date of transfer, eliminating any advantages or disadvantages to any party that would normally be associated with the passage of time.

The transfers between the RRB, SSA, HCFA and Treasury re-distribute cash among the several trust funds through the periodic determination and transfer of:

> ". . . the amount, if any, which if added to or subtracted from the Federal Old-Age and Survivors Insurance Trust Fund, the Federal Disability Insurance Trust Fund and the Federal Hospital Insurance Trust Fund would place each such Trust Fund in the same position in which it would have been if (A) service as an employee after December 31, 1936, had been included in the term "employment" as defined in the Social Security Act and in the Federal Insurance Contributions Act and (B) this Act had not been enacted."[3]

The translation of the legally mandated transactions into business and accounting terms drives decisions concerning the accounting treatment.

The FI transfer amount is determined after the publication of annual financial statements for the period 1937 through the end of the preceding fiscal year. Since the actual amount of the FI transfers between the RRB, SSA and HCFA will not be known until after the financial statements are published, the RRB estimates receivables and payables for financial statement reporting purposes, in accordance with traditional accrual accounting principles.

The RRB's Bureau of Fiscal Operations believes that accrual accounting best represents the financial relationships between the several agencies involved and most accurately depicts the agency's financial position.

[3] 45 USCS § 231f(2)

Based on our analysis of prior financial statements and pertinent public and governmental accounting literature, the OIG believes that non-accrual accounting for FI transactions would provide a more consistently reliable presentation than the present accrual treatment.

In addition, we believe that accrual of FI receivables and payables is not entirely consistent with applicable Federal standards and definitions. The agency has properly classified the RRB-SSA and RRB-HCFA fund transfers as "transfers without reimbursement." However, the FASAB standards, as well as the related accounting entries and definitions as promulgated by Treasury, appear to assume non-accrual treatment for such transfers.

Following is a description of the various fund transfers that comprise the FI followed by a discussion of the accounting issues.

The Transfer Between the RRB and SSA

Pursuant to the applicable provisions of the RRA, the RRB and SSA make an annual determination of the amount that would place SSA's trust funds in the same position that they would have been if the RRA had never been enacted.[4]

The annual determination, made jointly by SSA and RRB, occurs no later than June 15 for the period January 1, 1937 through the end of the most recent fiscal year. The related fund transfers must take place within ten days of the determination.

The initial FI determination, for the twenty-five year period January 1937 through June 1952, favored SSA. Subsequent annual determinations have always favored the RRB.

The amount of funds transferred is the result of a statistical projection based on the scenario "what if the RRA had never been enacted and all railroad workers had been covered by the Social Security Act since its inception." When the number of railroad workers is high relative to the number of retirees, as in the early years of the Railroad Retirement and Social Security programs, this scenario favors SSA. The reverse

[4]The trust funds impacted are SSA's Old Age and Survivor Insurance and Disability Insurance trust funds and the RRB's Social Security Equivalent Benefit Account.

situation exists today. Few workers support a system with many beneficiaries. As a result, since 1953, the FI has favored the RRB.

The amount of money transferred between the SSA and RRB trust funds is computed entirely under the theoretical scenario described above. The calculation does not consider any provision of the RRA because the basic premise of the FI is a "what if the RRA had never been enacted."

The RRB-SSA FI transfer is a funding source that is closely associated with an increase in RRA benefits enacted with the same legislation. However, the FI is not a true reimbursement because it is **not** computed based on any expense actually incurred by the RRB.

The proceeds of the RRB-SSA determination and transfer are deposited into the SSEB account. Similarly, the RRB charges the SSEB account for the amount of SSA benefits that RRB beneficiaries ***would have*** been paid by SSA if the RRA had never been enacted and railroad workers had been covered by Social Security and Medicare since the inception of those programs. The amount charged is calculated by statistical projection. Appendix IV presents a discussion of the SSEB account and benefit payment charges.

The RRB prepares its financial statements on the accrual basis of accounting.[5] As a result, the FI transfer between the RRB and SSA has been subject to accrual since the agency began preparing accrual basis financial statements in 1986.

The RRB recognizes an intra-governmental account receivable on its balance sheet at September 30. The amount recognized is an estimate of the outcome of the actual FI determination that will be completed the following June. The agency also recognizes a "Transfer-in" among the financing sources reported on its "Statement of Changes in Net Position." The amount recognized as a "Transfer-in" equals the current-year estimated account receivable adjusted for any over or under estimate in the prior year's account receivable.

The Transfer Between the RRB and HCFA

[5]The Dual Benefit Payments Account is an exception. That account is funded by appropriation and is accounted for entirely on the cash basis. However, the Dual Benefit Payments Account is not impacted by any FI transaction.

The annual transfer of funds from the RRB to HCFA as part of the FI is the mechanism that funds the insurance of railroad workers for Medicare benefits. However, the amount transferred is not the sum of amounts paid by individual workers and employers. Rather, it is a statistical projection based on aggregate payrolls, tax rates and allocated administrative expenses.

The amount of funds transferred is the product of a statistical estimate of the amount of taxes that the Medicare program would have collected from railroad employees had they been covered under the Social Security Act (instead of the RRA). The estimated taxes are reduced by the amount of administrative expenses that HCFA would have incurred had railroad payrolls been covered under the Social Security Act.

The annual determination and subsequent fund transfer are intended, pursuant to the FI provision of the RRA, to place HCFA's trust fund in the same position that it would have been if the RRA had never been enacted. Railroad employees do not pay Medicare taxes directly because their employment is not covered by the Social Security Act. RRA payroll tax rates have been established at levels intended to fund both retirement and Medicare benefits.

The RRB gives this transaction the same full accrual accounting treatment that is applied to the RRB-SSA transfer. The RRB recognizes an intra-governmental account payable on its balance sheet at September 30. The amount recognized is an estimate of the outcome of the actual FI determination that will be completed the following June. The agency also recognizes a "Transfer-out" among the financing sources reported on its "Statement of Changes in Net Position" for the year. The amount recognized as a "Transfer-out" equals the current-year estimated account payable adjusted for any over or under estimate in the prior year's account payable.

The Transfers Between the RRB and Treasury

In addition to the RRB-SSA and RRB-HCFA transfers, the RRA also provides for transfers between the RRB and the Treasury's general fund.

In 1983, the RRA was amended to ***mandate*** a monthly estimate of the net result of the RRB-SSA and RRB-HCFA FI determinations. If the amount estimated favors the RRB, the RRB receives the net amount from the Treasury. The purpose of this amendment was to relieve cash-flow problems associated with the timing of the annual FI determination and transfer process which takes place eight months after the end of the fiscal year.

The law also requires that, within 10 days of the RRB-SSA and RRB-HCFA transfers, the RRB re-transfer to Treasury, with interest, the funds previously transferred by Treasury to the RRB. The law does not provide for return of funds to Treasury unless and until the RRB-SSA and RRB-HCFA transfers are completed.

The RRB accrues a "Debt" classified as an "Intragovermental Liability" on the balance sheet in the amount of the 12 transfers (plus interest) related to the monthly determinations made during the preceding fiscal year.

The Case for Non-Accrual Treatment

The accrual accounting treatment presently used for FI transactions has, in the past, led to material misstatement of the RRB's financial statements. We believe that the application of accrual accounting to FI receivables and payables is not entirely consistent with current standards and definitions.

In the "Letter to Management" issued in conjunction with the OIG's audit of the RRB's FY 1998 financial statements, we recommended a change in accounting principle to record and report on FI amounts during the year of settlement. That recommendation has not been implemented.

A discussion of the accounting issues as they relate to the transactions that comprise the FI follows.

<u>The RRB-SSA and RRB-HCFA Transfers</u>

In SFFAS #7, "Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting," FASAB specifically classified the RRB's FI as an "other financing source."

> "The financial interchange does not arise from an exchange transaction because it is a reallocation of resources among funds, all of which are financed primarily from non-exchange revenue. Furthermore, the nature of this reallocation is such that the transferring entity does not receive anything of value and the recipient entity does not sacrifice anything of value."[6]

SFFAS #7 states that the FI transactions should be classified in the financial statements as "Transfers-in" and Transfers-out" by the recipient and transferring entities respectively. The "transfer-in" is a positive financing source, the "transfer-out" is a negative financing source. This statement also provides that, when cash is transferred without reimbursement between agencies, the amount recorded by both entities is "the transferring entity's book value of the asset."[7]

The account definitions for the U.S. Government Standard General Ledger state that "transfers-in" and "transfers-out," when made without reimbursement, are recorded at the book value of the transferring entity ***as of the transfer date.***[8] This language indicates that non-accrual treatment is expected. The fact that the asset being transferred is cash should not alter the interpretation. The Treasury Financial Manual uses specific language, such as "transferred or to be transferred," when accrual treatment is indicated.

Accrual treatment of the FI transactions is inconsistent with the requirements of SFFAS #1 "Accounting for Selected Assets and Liabilities." SFFAS #1 states that a federal entity should recognize a receivable when it "establishes a claim to cash or other assets against other entities, either based on legal provisions, such as payment due date . . . or goods or services provided."[9] None of the FI transactions involve the provision of goods or services and the due dates for all parts of the FI are after the balance sheet date.

As in asset recognition, due dates are a key factor in applying standards for liability recognition. SFFAS #5 "Accounting for Liabilities of the Federal Government" states

[6] SFFAS #7 Paragraph 343.
[7] SFFAS #7 Paragraphs 343 and 344.
[8] Book value is defined as the value of anything as shown by the books of account of the business owning it.
[9] SFFAS #1 Paragraph 41

that, for federal nonexchange transactions, a liability should be recognized for any unpaid amounts due as of the reporting date.[10] A nonexchange transaction arises when one party to a transaction receives value without directly giving or promising value in return.[11]

The RRB-SSA and RRB-HCFA transfers are “nonexchange” transactions for which the due dates are after the reporting date. Based on this analysis, the OIG believes that the present full accrual accounting treatment is inconsistent with FASAB pronouncements and the definitions in the U.S. Government Standard General Ledger.

The RRB’s Bureau of Fiscal Operations believes that accrual accounting best represents the financial relationships between the several agencies involved and most accurately depicts the agency’s financial position.

[10] SFFAS #5 Paragraph 19
[11] SFFAS #5 Paragraph 24

The RRB-Treasury Transfers

The RRB presently accrues an intergovernmental liability, classified as "Debt" on the balance sheet, representing the total amount of cash transfers (plus interest) from Treasury, made during the preceding 12 month period under the FI provisions of the RRA. The identification of this segment of the FI as a "debt" transaction drives the present accounting and financial reporting treatment.

The OIG believes that a full examination of FI should include an examination of the RRB-Treasury transfers. Based on our review of the other aspects of the FI, re-classification of the RRB-Treasury "debt" transactions to "transfers-in, transfers-out" might be justifiable. As such, they would be subject to recording and reporting during the period when the transfers actually take place.

Congress established the monthly transfers from Treasury to the RRB in order to improve the RRB's cash-flow. Below is an outline of key aspects of the RRB-Treasury transfers:

- RRA **mandates** the transfer of funds, it is not optional;
- the RRB does not realize or recognize borrowing authority related to the FI;
- the funds transferred are not required to be re-transferred back to Treasury ***until, and unless***, the transfers with SSA and HCFA have taken place.

Reclassification of the RRB – Treasury transfer as an "other financing source" instead of as "Debt" would be consistent with an overall conceptual view of the entire package of related FI transactions as a reallocation of assets. As previously stated, all the various transfers take place with interest calculated at the same rate, thus eliminating any advantages or disadvantages associated with the passage of time.

Recommendation

We recommend that the Bureau of Fiscal Operations submit a request for an interpretation of current Federal accounting standards as they apply to the FI to the Accounting and Auditing Policy Committee of the Federal Accounting Standards Advisory Board (Recommendation #1).

Management's Response

The Bureau of Fiscal Operations has agreed to prepare the recommended request for consideration by the agency's three-member Board. In their response, the Bureau of Fiscal Operations has also quoted from a letter in which the Executive Director of FASAB concurs with the agency's position in favor of accrual accounting for FI transactions.

The full text of management's comments is included as Appendix VI to this report.

OIG'S Comments

In the same correspondence cited by the Bureau of Fiscal Operations, the Executive Director of FASAB also stated:

> "In my capacity as Executive Director of the Federal Accounting Standards Advisory Board (FASAB) I am not able to provide authoritative guidance on federal accounting or auditing issues . . .
>
> Possibly my observations will help you and your Office of Inspector General (OIG) resolve these issues. If not, please let me know, so that we may discuss other alternatives for addressing the issues. These might include referring the matter to the Accounting and Auditing Policy committee (AAPC). . ."

The OIG believes that authoritative guidance, obtained through a formal process, will ensure a definitive solution to this longstanding controversy. Our report is intended to facilitate that process by providing a high level of technical detail concerning all aspects of the FI.

DISCLOSURE

The notes to the financial statements, an integral part of those statements, present additional disclosures concerning the details of FI transactions.

As previously discussed, the RRB accounts for all FI transactions on the accrual basis of accounting. The financial statements include estimated receivables, payables and financing sources related to each transaction included in the FI. These estimates are prepared by the RRB’s Bureau of the Actuary.

The estimates are “as of” and “for the fiscal year ended” September 30. The financial statements are published the following March. The actual amount of these transactions will not be known until the FI determination and transfer is completed in June.

Events that are expected to have monetary impact on the FI determination, but for which no monetary estimate can be made, may be pending on September 30. Such events are contingencies that require financial statement disclosure. In FY 1998, financial statement disclosures were expanded to include the past effect of such pending events. However, no disclosure of these events was made in the published financial statements for the years actually impacted.

Since the impact of the pending event cannot be quantified in monetary terms (which would permit full recognition), SFFAS #5 requires disclosure in the notes to the financial statements, The RRB should disclose any contingencies that have at least a reasonable possibility of reducing the value of the FI receivables and payables recognized in the financial statements.

Recommendation

We recommend that, as part of the financial statement preparation process, the Bureau of Fiscal Operations contact the Bureau of the Actuary to inquire about pending events that could alter the value of the FI receivables and payables and make disclosures as
appropriate (Recommendation #2).

Management’s Response

The Bureau of Fiscal Operations concurs with the recommendation.

Management's Discussion and Analysis

"Management's Discussion and Analysis," the narrative overview published with the RRB's FY 1999 financial statements, does not adequately communicate the extent to which the Railroad Retirement program is financially dependent on the Social Security system.

The agency's published financial statements include a variety of facts and statistics describing the origins, purpose, effect and magnitude of the FI. The information presented is plentiful and factual. However, it is scattered throughout the document. In addition, the presentation tends to rely on descriptions that have specific institutional meaning within the RRB but only limited meaning to the general public.

The narrative does not highlight the importance of the FI as a financing source. The FI, which comprised 32% of total financing in FY 1999, was described as one of several "other sources of income." By comparison, payroll taxes, which represent 48% of total financing, are described as the "primary source of income" to the Railroad Retirement system.

The narrative does not describe the FI in meaningful terms. The FI is described as a link "under which, in effect, the portion of railroad retirement annuities that is equivalent to social security benefits is reinsured through the social security system." The presentation also includes the statement, based on the language of the RRA, that the purpose of the FI is:

> ". . . to place the social security trust funds in the same position they would be in if railroad service were covered by the social security program instead of the railroad retirement program."

Although both of these descriptions have been used for over 45 years, they do not convey the role of the FI as a key financing source.

Recommendation

We recommend that the Bureau of Fiscal Operations review and revise the narrative presentation of FI information published with the financial statements in order to better communicate the role of the FI in agency financing (Recommendation #3).

Management's Response

The Bureau of Fiscal Operations concurs with the recommendation.

IMPACT OF THE FI ON THE AUDITOR’S OPINION

Independent public accountants and the OIG issued disclaimers of opinion on the RRB’s financial statements for FY 1993 – FY 1999.[12] Beginning with FY 1994, the auditors cited a scope limitation related to the accrual estimates used to report FI receivables and payables as the basis for their disclaimer on the financial statements.[13]

Following is a discussion of the basis for the OIG’s continued disclaimer on the RRB’s consolidated statements. We also discuss the impact of accrual accounting for FI transactions on the combining statement for the SSEB account.

The Consolidated Financial Statements

The OIG conducts audits of the RRB’s consolidated financial statements in compliance with requirements established by OMB. OMB Bulletin 98-08 requires that the auditors express an opinion “as to whether the reporting entity’s Principal Statements and Required Supplementary Stewardship Information are fairly presented in all material respects in conformity with Federal accounting standards.”

OMB Bulletin 98-08 also establishes a hierarchy of accounting principles and standards that comprise generally accepted accounting principles for the Federal government. Greatest authority is placed in the “Statements of Federal Financial Accounting Standards” (SFFAS), the related interpretations and the OMB Form and Content bulletin in effect for the period under examination.

As previously stated, the OIG has concluded that, as regards the FI transfers between the RRB and SSA and the RRB and HCFA, the present combination of full accrual accounting is inconsistent with FASAB pronouncements and the U.S. Government Standard General Ledger.

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[12] Audits of the RRB’s financial statements were conducted by Arthur Andersen LLP(FY 1993 –FY 1995), KPMG Peat Marwick LLP (FY 1996) and the OIG (FY 1997 - FY 1999).

[13] Arthur Andersen LLP did not cite the FI as a cause for its disclaimer of opinion on the FY 1993 financial statements. Completion of the first audit of the agency’s financial statements was inadvertently delayed until after the FI determination and transfer had been completed for the fiscal year under examination.

In addition, computation of the accruals involves extensive estimation. Because of the complexity of the computation, the predictive value of the accrual estimate can only be tested by comparison of prior year estimates with actual outcomes. Our analysis indicates that in prior years the use of accrual estimates has resulted in significant differences between the amounts accrued and the actual settlement.

A comparison of FI accrual accounting estimates with actual settlement amounts for fiscal years 1991 through 1998 disclosed differences that ranged between .4% and 15% (see Appendix I). These differences had the largest impact on the reporting of “Excess of Revenue and Financing Sources Over Total Expenses,” the largest factor influencing a change in net position between reporting periods. That item was misstated between .9% and 69%. A table summarizing the financial reporting effect of the use of estimates on the consolidated statements is presented as Appendix II to this report.

The “Statement of Changes in Net Position” is one of the principal statements and is prepared to communicate whether the agency’s financial position improved or deteriorated over the period. The use of accrual accounting estimates, as they are presently prepared, adversely impacts the ability of management to fairly present the agency’s results of operations in the financial statements.[14]

The Bureau of the Actuary prepares the FI accrual accounting estimates more than eight months prior to the actual settlement date. These estimates represent the best available information concerning the future outcome of the interchange calculation prior to the final settlement. The Bureau of the Actuary has stated that no better information is available for inclusion in financial statements unless such statements are published after determination of the final settlement amount. A discussion of the complexity of the FI is presented in Appendix III.

[14] Effective with FY 1998, the “Statement of Operations and Changes in Net Position” was replaced by the “Statement of Changes in Net Position.” The new statement includes the line items: “Net Results,” “Net Change in Cumulative Results of Operations” and “Change in Net Position.”

The annual determination, because it takes place after the financial statements are published, cannot provide audit evidence or serve as a basis for adjustment of the accrual estimates.

We have concluded that the use of accrual accounting estimates to report FI payables and receivables has, in the past, resulted in material misstatement of the RRB's financial statements. Disclosure of the historical differences between amounts estimated for financial statement reporting and amounts ultimately realized does not sufficiently compensate for potential misstatement in current reporting periods. As a result, the OIG was precluded from expressing an opinion on the RRB's financial statements for FY 1999.

In the "Letter to Management" issued in conjunction with the OIG's audit of the RRB's FY 1998 financial statements, we recommended a change in accounting principle "to record and report on financial interchange amounts during the year of settlement." Accordingly, we make no further recommendations for corrective action.

The Combining Statement for the SSEB Account

The RRB publishes both consolidated financial statements and combining statements for each of its program operations and financial components. The use of accrual accounting estimates for the FI transactions directly impacts the combining statement for the SSEB account in a manner similar to that previously described for the consolidated statements. However, the impact on the combining statements for the SSEB account is much greater because the FI is the single largest source of financing for that account. The FI represented over 60% of total financing to the SSEB account in FY 1999. By comparison, the FI comprised 32% of total agency financing.

Although we conduct our audit of the agency's financial statements for the purpose of expressing an opinion on the consolidated statements only, the impact of the use of accrual estimates on the SSEB account deserves consideration.

Receivables and Payables

As previously discussed, the use of accrual accounting estimates to report FI receivables and payables has, in the past, caused misstatement of the largest component of "Changes in Net Position" in the consolidated statements. The impact is magnified in the SSEB account, distorting the reported "Net Position" in the combining statements. The impact on net position has ranged between 1% and 35% during the past eight years.

Benefit Charges

Expenses for tier I benefits paid under the RRA are split between the Railroad Retirement, SSEB and Dual Benefits Payments accounts. Charges for benefit payments are initially allocated between the three accounts on an estimated basis as payments are issued. The allocation between the Railroad Retirement and SSEB accounts is adjusted periodically based on FI experience. This adjustment is discussed more fully in Appendix IV.

The first adjustment of benefit charges between the two accounts was made in 1997 for the period 1984 to 1994 and resulted in a transfer of $843 million from the SSEB account to the Railroad Retirement Account. Subsequent adjustments were made in 1997 and 1998 for $75.2 and $13.9 million respectively. The most recent adjustment, $29 million for the period 1984 through 1997, was made in 1999.

The RRB does not accrue inter-fund receivables and payables to account for the periodic adjustment of benefits charged to the SSEB account. This is inconsistent with the accrual accounting principles under which the agency currently prepares its financial statements. Since the RRB prepares its principal statements on a consolidated basis, only the individual combining statements for the RRA account and SSEB account are subject to misstatement as a result of the non-accrual of this item.

HISTORY OF THE ACCURACY OF THE FINANCIAL INTERCHANGE ACCRUAL ACCOUNTING ESTIMATES

Below is a comparison of the accrual accounting estimates used to prepare the RRB's financial statements with the actual amounts transferred. All amounts shown include both principal and interest.

Although the accuracy of the accrual estimate varies from year to year, the basic estimation methodology has not changed. The FI determination process is subject to periodic changes in the way that the "what if" scenario of the FI is interpreted. A detailed discussion of the FI calculation and the related accrual accounting estimate is presented in Appendix III.

Presented below is a comparison of the accrual accounting estimates as prepared by the Bureau of the Actuary for inclusion in the agency's annual financial statements with the actual results of the determination through that fiscal year.

The impact of the use of these estimates on the agency's financial statements is presented in Appendix II.

RRB-SSA Transfer

	Accrual Accounting Estimate	Actual	Difference	Actual Versus Estimate
FY 1989	$2,863,600,000	$2,874,100,000	$(10,500,000)	100.37%
FY 1990	3,043,800,000	3,261,600,000	(217,800,000)	107.16%
FY 1991	3,230,200,000	3,035,500,000	194,700,000	93.97%
FY 1992	3,319,800,000	3,268,100,000	51,700,000	98.44%
FY 1993	3,399,400,000	3,367,300,000	32,100,000	99.06%
FY 1994	3,491,800,000	3,944,700,000	(452,900,000)	112.97%
FY 1995	3,567,100,000	3,393,100,000	174,000,000	95.12%
FY 1996	3,642,400,000	3,581,900,000	60,500,000	98.34%
FY 1997	3,677,400,000	3,650,600,000	26,800,000	99.27%
FY 1998	3,664,600,000	3,650,600,000	14,000,000	99.62%

HISTORY OF THE ACCURACY OF THE FINANCIAL INTERCHANGE ACCRUAL ACCOUNTING ESTIMATES

RRB-HCFA Transfer

	Accrual Accounting Estimate	Actual	Difference	Actual Versus Estimate
FY 1989	$347,773,000	$346,300,000	1,473,000	99.58%
FY 1990	336,698,000	332,300,000	4,398,000	98.69%
FY 1991	340,872,000	354,500,000	(13,628,000)	104.00%
FY 1992	397,926,000	381,000,000	16,926,000	95.75%
FY 1993	379,912,000	394,400,000	(14,488,000)	103.81%
FY 1994	389,570,000	379,200,000	10,370,000	97.34%
FY 1995	393,110,000	382,900,000	10,210,000	97.40%
FY 1996	385,630,000	400,600,000	(14,970,000)	103.88%
FY 1997	403,300,000	400,900,000	2,400,000	99.40%
FY 1998	410,950,000	411,300,000	(350,000)	100.09%

NET EFFECT

Presented below are the RRB-SSA transfer receivables less the RRB-HCFA payables. The differences between the accounting estimate and the actual settlement are used in Appendix II to illustrate the financial statement impact of the use of FI estimates.

	Accrual Accounting Estimate	Actual	Difference	Actual Versus Estimate
FY 1989	$2,515,827,000	$2,527,800,000	(11,973,000)	100.48%
FY 1990	$2,707,102,000	$2,929,300,000	(222,198,000)	108.21%
FY 1991	$2,889,328,000	$2,681,000,000	208,328,000	92.79%
FY 1992	$2,921,874,000	$2,887,100,000	34,774,000	98.81%
FY 1993	$3,019,488,000	$2,972,900,000	46,588,000	98.46%
FY 1994	$3,102,230,000	$3,565,500,000	(463,270,000)	114.93%
FY 1995	$3,173,990,000	$3,010,200,000	163,790,000	94.84%
FY 1996	$3,256,770,000	$3,181,300,000	75,470,000	97.68%
FY 1997	$3,274,100,000	$3,249,700,000	24,400,000	99.25%
FY 1998	$3,253,650,000	$3,239,300,000	14,350,000	99.56%

FINANCIAL STATEMENT IMPACT

FINANCIAL INTERCHANGE ACCRUAL ACCOUNTING ESTIMATES[15]

	FY 1996	FY 1995	FY 1994	FY 1993	FY 1992	FY 1991
DIFFERENCE BETWEEN THE ACCRUAL ESTIMATE AND THE ACTUAL FI SETTLEMENT[16]	$75,470,000	$163,790,000	($463,270,000)	$46,588,000	$34,774,000	$208,328,000
Percentage	2.32%	5.16%	14.93%	1.54%	1.19%	7.21%
IMPACT ON INCOME STATEMENT						
FROM PRIOR YEAR	($163,790,000)	$463,270,000	($46,588,000)	($34,774,000)	($208,328,000)	$222,198,000
CURRENT YEAR	75,470,000	163,790,000	(463,270,000)	46,588,000	34,774,000	208,328,000
	============	============	============	============	============	============
INCOME OVER (UNDER) RECOGNIZED	($88,320,000)	$627,060,000	($509,858,000)	$11,814,000	($173,554,000)	$430,526,000
Total Revenue and Financing Sources	$10,268,260,042	$10,836,666,507	$10,266,490,957	$9,770,806,292	$10,234,328,904	$10,098,145,607
Income Over (Under) Recognized as a Percentage of Total Revenue and Financing Sources	-0.86%	5.79%	-4.97%	0.12%	-1.70%	4.26
Excess Of Revenue And Financing Sources Over Total Expenses	$564,442,028	$1,197,488,545	$734,467,955	$337,864,904	$992,657,643	$1,145,031,847
Income Over (Under) Recognized as a Percentage of Excess of Revenue and Financing Sources over Total Expenses	-15.65%	52.36%	-69.42%	3.50%	-17.48%	37.60%
TOTAL ASSETS	$18,881,897,649	$18,364,364,512	$17,036,994,951	$16,277,809,452	$15,821,289,324	$14,664,082,219

[15] The RRB's FY 1993 financial statements were the first to be audited under the provisions of the CFO Act. Delays in the audit process permitted inclusion of actual FI numbers in the audited statements. For purposes of this evaluation, the accrual estimates that were originally prepared for inclusion in the financial statements are presented here and related amounts have been adjusted accordingly.

[16] The "difference" presented on the first line is the net difference between estimate and actual for RBB-SSA receivable less the RRB-HCFA payable. An analysis of these differences is included in Appendix I.

Difference Between The Accrued Receivable And The Actual FI Settlement As A Percentage Of Total Assets[17]	0.32%	0.95%	-2.66%	0.20%	0.33%	1.33%

[17] The “difference” used in this comparison relates only to the RRB-SSA transfer and is presented on the first page of Appendix I.

FINANCIAL STATEMENT IMPACT
FINANCIAL INTERCHANGE ACCRUAL ACCOUNTING ESTIMATES[18]

	FY 1998	FY 1997
DIFFERENCE BETWEEN THE ACCRUAL ESTIMATE AND THE ACTUAL FI SETTLEMENT	$14,350,000	$24,400,000
Percentage	0.44%	0.75%
IMPACT ON INCOME STATEMENT		
FROM PRIOR YEAR	($24,400,000)	($75,470,000)
CURRENT YEAR	14,350,000	24,400,000
	============	============
INCOME OVER (UNDER) RECOGNIZED	($10,050,000)	($51,070,000)
Total Financing Sources	9,638,335,776	9,251,744,590
Income Over (Under) Recognized as a Percentage of Total Financing Sources	-.10%	-.55%
Net Change in the Cumulative Results of Operations	1,175,073,202	614,718,509
Income Over (Under) Recognized as a Percentage of Net Change in the Cumulative Results	-.86%	-8.31%
TOTAL ASSETS	$20,757,509,818	$19,666,951,727
Difference Between The Accrued Receivable And The Actual Fi Settlement As A Percentage Of Total Assets[19]	.07%	.14%

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[18] The “difference” presented on the first line is the net difference between estimate and actual for RBB-SSA receivable less the RRB-HCFA payable. An analysis of these differences is included in Appendix I.

[19] The “difference” used in this comparison relates only to the RRB-SSA transfer and is presented on the first page of Appendix I.

The Use of Estimates in the FI Determination and Related Accrual Accounting Estimate

The FI accrual accounting ***estimate*** is an ***estimate of a complex estimate***. Following is a description of the largest component of the FI, the RRB-SSA transfer. The RRB-HCFA and RRB-Treasury transactions are based on similar computations.

CALCULATION OF THE ACTUAL RRB-SSA FI TRANSFER AMOUNT

The FI is an ongoing cumulative process. Each determination covers the period 1937 through the most recent fiscal year-end.

The amount of funds transferred between the two agencies is the result of a statistical projection based on the scenario "what if the RRA had never been enacted and all railroad workers had been covered by the Social Security Act since its inception."

Calculation of the annual FI transfer amount is a year-long process that culminates with an agreement between the RRB and SSA concerning the amount to be transferred pursuant to the applicable provisions of section 7(c)(2) of the RRA.

<u>Determination of the Transfer Amount</u>

The FI is computed using statistical methods including large samples of RRB beneficiaries and currently employed railroad workers. All calculations are performed under the provisions of the Social Security Act. The computation takes into consideration:

1. the amount of taxes that ***would have been*** collected on railroad earnings under the provisions of the Social Security Act;

2. the amount of benefits that ***would have been paid*** to workers and their families under the provisions of the Social Security Act; and

3. the additional administrative costs that the Social Security system ***would have*** incurred had that system covered the railroad industry.

The Use of Estimates in the FI Determination and Related Accrual Accounting Estimate

Since each annual determination is cumulative, the amount transferred each year is the difference between the current-year determination and the prior-year determination.

The Use of Estimates in the FI Determination and Related Accrual Accounting Estimate

The provisions of the RRA are not taken into consideration in the FI determination. Benefits payable and taxes collectible under the RRA **are not** part of the calculation. As a result, the FI is not a direct reimbursement of expense.

As part of the FI, SSA receives credit for Social Security benefits paid to individuals entitled to benefits under both the RRA and the Social Security Act. A discussion of these cases is presented in Appendix V.

Because the FI determination is cumulative, no FI determination is ever truly final. The FI is constantly subject to revision. Changes in the way that the "what if" scenario of the FI is interpreted are applied retroactively to prior periods as appropriate.

Timing

In May of each year, SSA and RRB jointly determine the amount that must be transferred between the two systems, as of the prior fiscal year-end, to place the Social Security trust funds in the same position they would have been had the RRA never been enacted. The transfer of funds takes place in early June.

The Use of Estimates in the FI Determination

The annual FI determination uses estimates for certain key items pertaining to the most recent fiscal year because actual figures are not available in time to meet the deadlines established by law. These estimates are replaced with actual information in subsequent determinations. Below is an illustration of the timing of estimates in the annual FI determination.

ESTIMATES VERSUS ACTUALS

	40th Determination Thru 9/30/91	41st Determination Thru 9/30/92
Date Agreed by SSA and RRB	**05/12/1992**	**05/04/1993**
Period Affected		
December 1990 and Prior	Actual	Actual
January – September 1991	Estimate	Actual

The Use of Estimates in the FI Determination and Related Accrual Accounting Estimate

October – December 1991	Not Applicable	Actual
January – September 1992	Not Applicable	Estimate

The Use of Estimates in the FI Determination and Related Accrual Accounting Estimate

For example, actual wage and tax information was not available for January – September 1991 in time to permit completion of the annual FI determination within the timeframe established by law. As a result, estimates were used.

As actual data concerning wages, benefits and taxes becomes available, estimates are replaced by actual numbers in subsequent determinations. Since the FI determination is cumulative, the use of estimates has no permanent impact.

CALCULATION OF THE ACCRUAL ACCOUNTING ESTIMATE

The accrual accounting estimate is an estimate of the outcome of the above described process. The ability of the Bureau of the Actuary to predict the outcome of the actual determination is limited by the quality of the available data and the complexity of the FI determination process.

Data availability impacts the accuracy of the accrual accounting estimate because the estimate cannot be prepared using the same data inputs that will be used in making the annual FI determination. That data is not yet available.

In addition, the FI determination process is subject to periodic changes in the way that the “what if” scenario of the FI is interpreted. Applying such changes is labor intensive, detail oriented work that cannot be cost-effectively duplicated as part of the accrual estimation process. As a result, there may be some variables that cannot be factored into the accrual accounting estimate.

For example, the large difference between the FI receivable recognized in the FY 1994 financial statements and the actual amount received, $452.9 million, is attributed to consideration of special filing procedures for reduced age spouse benefits at SSA. These procedures were included for the first time in the FI determination for the period ended September 30, 1994 and had retroactive impact for the period 1978 through 1994.

The Social Security Equivalent Benefit Account

Prior to 1983, all RRA benefits and benefit financing sources were accounted for in a single trust fund, the Railroad Retirement Account. The Railroad Retirement Solvency Act of 1983 established the Social Security Equivalent Benefit (SSEB) Account, separate from the Railroad Retirement Account.[20]

The purpose of this fund segregation was to track the income and outgo related to the FI and that portion of RRA benefits designated as "Social Security Equivalent."

The SSEB services the various fund transfers that comprise the FI and retains the net proceeds, approximately $3 billion per year.

The SSEB is not charged for benefits paid under the RRA. Rather, the account is charged for the additional amount of SSA benefits that RRB beneficiaries ***would have*** been paid by SSA if the RRA had never been enacted and railroad workers had been covered by Social Security since its inception.

On an on-going basis, the RRB's Bureau of the Actuary determines the amount of benefit payment expense that should be charged to the RRA and SSEB accounts respectively. However, the initial allocation is a preliminary estimate that will later be revised in the form of an "annual adjustment" between the SSEB and RRA accounts. The adjustment is calculated using the same methodology and data used in the annual FI determination for the RRB-SSA and RRB-HCFA transfers.

Since the amount charged to the SSEB account is the result of a cumulative determination, none of the annual charges are ever truly "final." The amount of the annual adjustment attributable to any given year ranges between $20 million to over $200 million and typically favors the Railroad Retirement Account.

The first adjustment was made in May 1997 for the period October 1984 through December 1994. Subsequent adjustments have been made annually. There is a delay of approximately 18

[20] Public Law 98-76

The Social Security Equivalent Benefit Account

months between the close of the calendar year and the related adjustment to the SSEB account.

The Social Security Equivalent Benefit Account

This schedule delays the adjustment until "actual" numbers replace "estimates" in the FI determination for that period.[21] For example, the adjustment for benefits paid through fiscal year 1997 was made in July 1999.

Adjustment Pertains to the Period October 1, 1984 through:	Adjustment Date	Increase (Decrease) in the SSEB Account
December 31, 1994	May 1997	$ (843,103,433)
December 31, 1995	August 1997	(75,230,344)
December 31, 1996	July 1998	(13,926,666)
December 31, 1997	July 1999	(29,045,596)

The RRB does not accrue an estimate for the future adjustment of benefit charges between the SSEB and Railroad Retirement Accounts on the financial statements. Since the RRB prepares its principal statements on a consolidated basis, only the individual combining statements for the RRA account and SSEB account are impacted by the non-accrual of this item.

[21] Appendix III presents a detailed discussion of the use of estimates in the FI.

DUAL ENTITLEMENT TO SOCIAL SECURITY BENEFITS

Entitlement

Individuals may become entitled to benefits under both the Railroad Retirement and Social Security Acts. Entitlement to both benefits commonly occurs when an RRA annuitant has had both railroad and non-railroad employment or when a member of the annuitant's family group is entitled to Social Security benefits on their own earnings record.

As of September 30, 1999, approximately 30% of individuals receiving an annuity under the RRA were also receiving Social Security benefits.

Impact of Dual Entitlement on RRA Benefit Levels

When a person is entitled to benefits under both the Social Security and Railroad Retirement Acts, the tier I portion of their RRA annuity is reduced by the amount of any Social Security benefits payable.

Mechanics of Payment in Dual Entitlement Cases

In order to facilitate the coordination of Social Security and Railroad Retirement benefits, the RRB acts as "paymaster" for the Social Security benefit. The RRB makes payment to the beneficiary based on SSA's instructions. SSA receives and processes the application for Social Security benefits, advises the RRB of the amount of benefits to be paid and the date entitlement will begin. The RRB is reimbursed on a dollar-for-dollar basis for the actual cost of benefits.

In some cases, SSA pays the benefits directly and advises the RRB of the amount paid so that the RRB can make the appropriate RRA benefit reduction.

The FI

As part of the FI calculation, SSA receives credit for Social Security benefits actually paid. This adjustment eliminates the double charge to SSA that would otherwise result from the existence of individuals with entitlement to both Social Security and Railroad Retirement benefits. Without this credit, the FI calculation would charge SSA for the cost of theoretical benefit payments under the FI scenario while SSA was actually paying the benefits.

Management's Response